Introduction

One long-time observer (and occasional participant) in the telecommunications regulatory wars recently remarked to the effect that the United States was able to defeat Adolf Hitler *and* the Japanese Empire in less time than it has taken the government to permit telephone companies to bring effective competition to the cable monopoly. Given the egregiousness of the cable monopoly's exploitation (a euphemism) of consumers, the disingenuousness of its excuses ("If we can't overcharge consumers, where will we get the capital to build the Information Superhighway?"),[1] and especially now that the citizenry has voted competition "In" and regulation "Out," one might hope that the government would get its act together, manage simply to get out of the way, and let the competitive games begin.

Alas, that does not appear too likely. As we write, new legislation has been proposed that would put the brakes on even the heavily contorted video offerings regulators have heretofore created to permit telephone company competition for cable. Despite the increasing ubiquity of price-cap regulation, including its own home-grown heirloom variety, the FCC continues to torture itself (or permit itself to be tortured) over bizarre and largely irrelevant metaphysical distinctions concerning economically arbitrary common cost allocation. The courts have now pretty thoroughly nixed the legality of restraints on the telephone companies' freedom of speech using their *own* electronic printing presses. Prior to that, the regulators' vision/fantasy was, in essence, "build it and they will come." The view that a gate*way* operator, subject to a variety of significant operating handicaps,[2] will be able to bring effective competitive pressure to bear on a gate*keeper*, free to cut deals or refuse to deal, to discriminate in price or other terms and conditions of usage — so long as it does so within the boundaries of the Cable Act — strikes many as quaint and naive.

So what is to be done? In this paper we explore the genesis of the video dialtone model for telephone company provision of video services, the disabilities of that model, and the outline of a less regulatory, more even-handed framework for cable-telco competition in the public interest.

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[1] They might, of course, borrow rather than extort the funds. The fact that a good education promises certain advantages presumably does not warrant student thievery to raise tuition funds.

[2] These include the requirement to build capacity significantly in excess of the amount actually needed to provide a competing service.

Who Wears the White Hat?

The original motivation for in-market restrictions on telephone companies' freedom to supply cable television services was similar to that which underlay subsequent line-of-business restrictions on the divested Bell telephone operating companies. The FCC's cross-ownership bar reflected concern over whether telephone companies would discriminate in favor of their own cable operations when providing access to poles, ducts and conduits to competing services, and cross-subsidize their cable offerings by shifting costs to captive telephone ratepayers. The Commission's fear was, in essence, that telephone companies might supplant (*i.e.*, become) the local cable company.

Note that this fear only matters *if* telephone and cable companies are perceived as likely (potential or perhaps eventual) competitors for at least something. If they are not, it makes no economic difference if both services are supplied by the same firm any more than it matters whether TCI owns the cable monopoly in two or 222 localities.[3] Since in adopting the cross-ownership ban the Commission was quite explicitly limiting telephone companies' ability to compete, the Commission could have presumably only with difficulty (or a generously elastic sense of consistency) claimed a competitive rationale. Instead it alluded to the development of new broadband services including data distribution, information storage and retrieval, and facsimile and telemetry transmission, and expressed the view that these would be more likely to occur if cable was assured of an opportunity to compete. So cable initially wore the white hat.

Of course, with the advantage of 25 years' hindsight, it is now plain to see what a powerful competitive force the cable industry has been in the perfection of the aforementioned technologies. Where would, for example, facsimile be today without the FCC's foresight in adopting telephone/ cable cross-ownership rules?[4]

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[3] Indeed, in both examples there may well be positive differences (*viz.*, economies) associated with joint operations.

[4] The Commission's intuition might have been that faster innovation would be spurred by separate industries' mutual fears of being beaten to market and consequent loss of potentially important first-mover advantages. In our view, it would be very hard to argue that actual telephone company product and service innovations over the last quarter century have in any significant way been driven by the threat of being beaten by cable. This is not to imply that competition could not play a very significant role in driving more rapid deployment of new service capabilities in the future. In order to do so, however, competition must be permitted rather than restricted as it currently is.

In 1984, the Cable Communications Policy Act codified the FCC's cross-ownership rules and made it crystal clear that telephone companies were not to select or provide video programming over a cable system. According to the House Report that accompanied this legislation, the objectives were to "prevent the development of local media monopolies, and to encourage a diversity of ownership of communications outlets."[5] Of course, the legislation could not prevent the development of local media monopolies for that is what cable already was; to make matters worse for consumers, the legislation deregulated cable and simultaneously insulated it against competition from one of the most plausible sources, indeed perhaps the most likely source.[6] So in 1984 cable continued to wear the white hat, but now it had been given a lot of rope. Note again the governmental pursuit of diversity as a policy objective without reference to its instrumental significance (*i.e., e.g.,* in terms of competition).

But literally at the same time Congress was drawing the proverbial line in the sand, the sands (or silicon!) began to shift. The emergence of optical fiber technology stimulated new interest in integrated broadband networks. Such networks permit the efficient simultaneous transmission of very large volumes of information in the form of data, voice and full-motion video images. Given the restrictions on their ability to offer video entertainment services, this new technology presented the telephone companies with a particularly frustrating dilemma. On the one hand, the natural evolution of technology pointed to deployment of an intelligent broadband network to meet the evolving communications needs of industrial and residential users in an economically efficient way. On the other hand, full exploitation of the potential economies inherent in the use of fiber optics depends on a high expected volume of usage -- a problematic assumption for telephone companies given the regulatory restrictions on use and the provision of video service in particular.

In 1987, the FCC responded to these concerns by opening a Notice of Inquiry to review its own telephone/cable cross-ownership restrictions. This proceeding marked an important shift in the debate over telephone company provision of video services. The Commission had begun to perceive

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5 *See Cable Communications Policy Act of 1984, House Report,* January 23, 1984, p. 55.

6 The 1984 Cable Act also barred broadcasters from competing with local cable operators. The cable industry itself played a pivotal role in delaying competition from new entrants like DBS and "wireless" cable systems by seeking control over scrambling standards and by withholding popular programming services from would-be distribution competitors.

the technical convergence of cable and telephony with two important implications: (1) telephone companies could provide video services *over their own networks* — indeed, as a result of digitalization, one would be hard pressed to identify the specific character (content) of any particular bit of information being transported over the network; and (2) relaxation of its rules would stimulate competition with cable systems in the provision of video services.

As time passed, the latter consideration assumed ever increasing importance because the rate and customer service record of the deregulated cable industry was nothing to write home about; quite to the contrary, it was something to write Congress about and that is precisely what a great number of outraged citizens did. After the cable industry was deregulated in 1984, cable rates skyrocketed because cable possessed and exercised substantial monopoly power in most markets.[7] The result was that *cable's* market power began to be perceived as a very serious problem that needed to be addressed, and that telephone companies began to be perceived as part of the solution rather than as part of the problem. Thus did the white hat pass to the telephone companies, and the cable industry assume the role of the villain, an image it retains to the present — at least among consumers if not regulators actually charged with regulating the industry. Given all that rope by the 1984 Act, cable promptly proceeded to get itself tied up in knots.

In 1992, after delays brought about largely by cable industry opposition to *any* modifications of the total cross-ownership bar, the FCC finally amended its rules to permit telephone companies to provide "video dialtone."[8] The Commission's decision came at a time when Congress was considering legislation, which was ultimately enacted, to reregulate the cable industry reflecting an abundance of concern about cable's monopolistic performance in the absence of regulation. The 1992 Cable Act's regulatory scheme was, however, conceived as a transitional mechanism to

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[7] Strikingly, where competition was permitted, cable rates were significantly lower. The FCC found that prices were on average 16 percent lower in the relatively few markets where there was a competitive supplier. *See In the Matter of Implementation of sections of the Cable Television Consumer Protection and Competition Act of 1992*, MM Docket No. 92-266, Rate Regulation, Second Order on Reconsideration, Fourth Report and Order, and Fifth Notice of Proposed Rulemaking, Appendix C. *Consumers' Research* found that basic cable rates were 18 percent lower in competitive markets than in comparably-sized monopoly cable markets. Their research also found that in the noncompetitive markets fewer channels were provided (33 versus 40). *See* "How to Get Better Cable TV at Lower Prices," *Consumers' Research*, May 1990, p. 10.

[8] We note that the concept of video dialtone was first advanced by NTIA in *Video Program Distribution and Cable Television: Current Policy Issues and Recommendations*, NTIA Report 88-233 (June 1988).

constrain cable's monopoly power until competition develops and consumers have adequate multichannel video programming alternatives. Promotion of the emergence of effective competition through the entry of alternative distribution technologies is a critical element of the regulatory framework mandated by Congress.

Can Video Dialtone Actually Produce Effective Competition?

Before getting into the specifics of video dialtone, it is worth noting at the outset the strikingly anomalous treatment of telephone company entry into this service market. Heretofore, new entrants into various telecommunications markets have been afforded a variety of legs-up to enable them to mount effective competitive challenges to the dominant incumbent suppliers. Regulatory handicapping of competition has certainly been the rule rather than the exception in the United States and in other countries as well (*cf.* the United Kingdom). These encouragements not only included designation as a "nondominant" supplier with attendant relaxation of tariff filing requirements and minimal regulatory scrutiny, but also implementation on a programmatic basis of numerous affirmative regulatory actions to facilitate entry (*cf.* divestiture, equal access, access discounts, favorable discrimination in terms of interconnection rates, service unbundling, contractual "fresh-looks," *etc.*).

Whatever else telephone companies may be, the one thing they clearly are not is *dominant* competitors in markets for video services. Plainly it is impossible to dominate a market you're barely in, particularly in the face of fierce opposition from dominant incumbent cable monopolists. But in the case of telephone company entry into video services, no nondominant status has been afforded and there has been little effort to remove economic and legal barriers to entry.[9] Instead, the principal thrust (in effect if not intent) of regulation has been to make telcos live with the legal and economic barriers they confront in competing with cable monopolies, and, in consequence, to inhibit rather than facilitate competitive entry.

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[9] Compare this situation to that in the United Kingdom where, to promote competition, OFTEL (the British FCC) now contemplates offering discounted interconnection charges to new telecommunications network competitors, including foreign entrants like AT&T and Nynex. *See A Framework for Effective Competition*, December 1994, p. 32.

The FCC's 1992 Video Dialtone Order did indeed finally permit telephone companies to offer video service, but subject to numerous requirements and restrictions:

- Telephone company ownership of any programming service was strictly limited to no more than 5 percent;
- Telephone companies were required to offer a nondiscriminatory video dialtone platform;
- Telephone companies were required to build enough capacity so that a substantial portion would be available to independent programmers;
- Telephone companies were required to obtain regulatory authorization to construct facilities;
- Telephone companies were required to submit tariffs and justify them with extensive cost data;
- Telephone companies were required to separate the costs of regulated from non-regulated services; and
- Bell operating companies were required to comply with rules regarding open network architecture, network disclosure, and use of customer proprietary network information.

We note that each of these regulatory requirements creates an opportunity for the cable industry to use the process of regulation to delay competition, a point that has apparently not been lost on the chairman of the FCC,[10] whose agency, nevertheless, continues to pursue an unnecessarily regulatory path to competition. Many of these requirements are nothing out of the ordinary when it comes to the typical telephone company service offering, and the telephone companies themselves have become largely inured to coping with them. Nevertheless, it is worth reiterating that such requirements are usually imposed in the context of a telephone company providing a monopoly service. However, in this instance, the *cable companies* possess the monopoly, while the requirements fall oddly and asymmetrically on the telephone companies.

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[10] *See* Remarks of FCC Chairman Reed Hundt before the Washington Metropolitan Cable Club, December 20, 1994.

There are legitimate rationales for imposition of regulatory requirements on telephone companies wishing to offer video services, principally related to concerns about anticompetitive cross-subsidization at telephone ratepayers' expense. We will address these concerns presently, but, first, it is worthwhile to focus attention on those aspects of the FCC's paradigm that serve primarily instrumental objectives. It is important to comprehend the extent to which video dialtone is only an artifact of regulation. Ask yourself the following questions: If you were starting from scratch to foster competition for the cable monopoly, would you require a fledgling entrant to deploy capacity substantially in excess of that which it actually needs to provide a competing service as a condition for permission to compete? Or would you regard the imposition of such a requirement as erecting a barrier to competitive entry? Would you make it virtually impossible to assume risks associated with development of programming throughput for the new system? Or would you regard the development of competitive programming as a integral part of bringing effective competition to bear and desirable in its own right in terms of expanding consumer viewing options? Would you regard the imposition of such restrictions as erecting barriers to competition?

Requiring a nondiscriminatory video dialtone platform may be perceived by regulators as necessary to make the service look the way they think it needs to look (*viz.*, common carriage) to fit in the right regulatory box and not be mistaken for what it is actually trying to be — *viz.*, competition for cable, but it amounts to saying that to compete it is not sufficient to build a competing system — it is necessary to build two! Similarly, restraints on the ability to program a service and, thereby, promote its usage and growth, however necessary for purposes of legal differentiation, impose very substantial investment risks and clearly operate to deter entry. Surely rare would be the construction of a pipeline with no (at least contractual) guarantee of throughput. Indeed, there is a quite voluminous economic literature detailing the efficiency-enhancing properties of vertical integration in precisely the circumstances telephone companies confront in attempting to compete with cable.[11]

The FCC certainly had legitimate reasons for imposing these requirements in its Video Dialtone Order. The Commission was significantly constrained by the statutory telco/cable cross-ownership prohibition. In addition, it may have fallen prey to subtle — or not so subtle —

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[11] See Oliver E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (The Free Press, 1975); and *The Economic Institutions of Capitalism* (The Free Press, 1985).

institutional pressures to conform telephone company video offerings to the world it knows best — that of regulated common carriage. Surely a better way to promote competition for cable would simply be to relax the legal barriers to competition, and, thereby, avoid the need to create a hybrid whose mere viability, let alone competitive effectiveness, is highly questionable. In fairness to the Commission, it should be noted that the Commission favored relaxation of the cross-ownership bar and recommended that Congress alter its statutory bar. In the absence of reform and intervention by the courts, video dialtone, at least in theory, offered a way for telephone companies to supply a competitive video service.

The Courts have now virtually demolished the regulatory proscription on telco-provided programming. In 1993, a federal court ruled in favor of one of the RBOCs (Bell Atlantic) that the bar on telephone company provision of video programming (*i.e.*, content) constituted an unconstitutional abridgement of the right of free speech.[12] Shortly thereafter, each of the other six RBOCs, GTE and USTA filed suits seeking similar relief, and several federal courts have now rendered favorable opinions.

Snatching Defeat from the Jaws of Victory

The particular economic significance of these important First Amendment court victories is that they remove a major legal barrier to telephone company competition with cable. A telephone company, assuming it has prevailed in one of these recent cases, is no longer constrained by the cross-ownership bar, and may presumably undertake to supply traditional cable service without jumping through the FCC's numerous video dialtone hoops. If the cable companies are free from such an obligation, why should the telephone companies not also be? In particular, a telephone company need not, if it so chooses, provide service through a nondiscriminatory video dialtone platform (the cable companies don't; why should the telephone companies trying to compete have to?), nor is it any longer significantly restricted in terms of the kinds of arrangements it can transact with program suppliers.

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[12] *See Chesapeake and Potomac Telephone Company of Virginia v. FCC*, 830 F.Supp. 909 (E.D.Va.1993). The District Court's decision was subsequently upheld by the U.S. Court of Appeals in Docket No. 93-2340, slip op. (4th Cir., Nov. 21, 1994).

Many telephone companies may decide *not* to avail themselves of the opportunity to compete with cable through supply of a like service; they may wish to compete using the video dialtone model especially if their network deployment plans contemplate near-term deployment of a switched broadband architecture.[13] But even these telcos now face a much less steeply sloped incline thanks to their newly won freedom to be both medium and message providers.

Having thus been delivered to this copasetic economic realm by the transcendent power of the First Amendment, one might have hoped policymakers would leave well enough alone. No such luck. The FCC has opened a new rulemaking on telco provision of video programming that could threaten the telephone companies' court victories and substantially reduce their value in terms of the ability to compete effectively. The FCC has tentatively concluded that telcos should be permitted to provide video programming — as if it really possessed any leeway in reaching that conclusion given the various court verdicts undermining the Commission's authority to impose such restrictions on fundamental First Amendment freedoms — but unfavorable resolution of a variety of sub-issues could easily thwart many telcos' cable initiatives, particularly those which might entail the supply of a traditional cable service. The FCC may insist that telephone companies provide video programming on a common carrier basis,[14] rather than simply using the same method utilized by the cable industry itself.

The prospect of Congressional intervention is also potentially problematical. Legislation that places new regulatory burdens on nondominant competitors with the established cable monopolists will only serve to frustrate competition in much the same way the 1984 Act did. If legislative initiatives supply the opportunity to start from ground zero and get it right, why don't they actually avail themselves of the opportunity?

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13 With a switched architecture, the excess capacity required by the FCC's rules loom less large as an investment hurdle.

14 This could, for example, adversely affect provision of cable service to rural communities by telephone companies under the rural exemption. It would be highly ironical were an expansion of the number of communities potentially served under this type of exemption accompanied by effective constraints on telephone companies' ability to supply such service.

The Pursuit of Symmetry

What policy program is most likely to result in the greatest competitive benefits to cable consumers? In our view, as a matter of first principle that program will *not* limit the competitive means telephone companies can bring to bear in mounting competitive challenges. If some telephone companies want to offer cable services via traditional means, there should be no bars against their so doing. Those companies' offerings should be treated as cable service and should be subject to whatever regulation applies to cable service. Those offerings should most certainly not be treated as telephone company service just because they happen to be offered by entities and on facilities that also happen to supply telephone service.[15] In short, regulation should relate to the service being provided rather than to the company providing the service.

If other telephone companies wish to present competitive alternatives utilizing new network architectures and on a common carrier basis, more power to them. In either case, there should be no limitations on their capability to program their own services. Moreover, telephone companies should not have to purchase their freedom to compete in the public interest at the cost of foregoing legitimate economic comparative advantages that may derive from engaging in economically complementary businesses. Effective competition means letting companies capitalize on their comparative efficiencies — not restricting their ability to do so as a condition for permission to compete.

As we have suggested, a sound principle for public policymaking is the symmetrical treatment of comparable or like services. Where appropriate, we would prefer to see a symmetrical "hands-off" approach by regulators. However, if policymakers want to compel telephone companies to unbundle their network service capabilities, where the telephone network is deemed to constitute an essential facility, they ought also then to be willing to compel cable companies to unbundle *their* networks where cable's facilities are deemed to constitute a bottleneck. If "the final mile" is a bottleneck and economic access is to be mandated, it ought to be mandated for both. If customer premises equipment and inside wire are unbundled and deregulated (that is, in the control of the

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[15] We would note that there is ample precedent for a single company being a common carrier for some services and a non-common carrier for others. For example, LECs currently offer telephony as common carriers while offering enhanced services on an unregulated basis, using many of the same facilities.

customer) for telephony, then it ought to be for cable as well. If effective long-distance competition requires equal access to local telephone networks, why shouldn't equal access to local cable networks be mandated to promote competition in video programming delivery?

Similarly, if interactive video services are to be supplied on a video dialtone basis, then the rules governing their provision ought not to distinguish or discriminate on the basis of the *specific identity* of the service suppliers. If service transport prices are to be regulated by a price cap, the same type of cap ought to govern any supplier's offering.

Price caps, as only economic Luddites now fail to comprehend, are also the answer in terms of a simple and effective safeguard against anticompetitive cross-subsidy. Until recently in the federal arena and still in many state proceedings, the cable industry opposed pure price-cap regulation for telephone companies apparently out of fear that adoption of an effective competitive safeguard would mean the end of protection for cable from telephone company competition.

The governing principle underlying symmetrical regulation for provision of competitive services is simple and fundamental: The competitive process is incapable of identifying efficient suppliers and the genuinely most economic service offerings if regulation artificially advantages or disadvantages the merits of different suppliers' offerings. A program of regulatory symmetry under which all suppliers of a given service (whether it be video dialtone or conventional cable services) are treated equally and play by the relevant set of rules is required to ensure that effective competition and maximal benefits for the consuming public. "What's sauce for the goose is sauce for the gander" should be the guiding principle for Information Age regulatory policies genuinely conceived to promote effective competition in the public interest.

Conclusion

If the FCC is serious about its frequently proclaimed desire to substitute more effective competition for less effective regulation, it needs to stop inhibiting and start promoting competition on the real merits. In terms of video services, where the Commission itself concedes that, notwithstanding reregulation, the cable industry continues to exercise substantial monopoly power,[16] that means unshackling the telephone companies. The telephone companies pose a very highly credible competitive threat to the incumbent cable monopoly because of their specific identities, the technology they are capable of deploying, the technological evolution their networks are undergoing for reasons apart from video distribution, and last, but by no means least, their financial strength and perceived staying power. The cable industry's opposition to telephone company entry and its exploitation of the Commission's administrative processes to thwart telephone company competition speak volumes for the perceived strength of the competition telephone companies can be expected to bring to bear.

The time has come for the FCC to start allowing carriers to capitalize on the economies of scope that inhere in an integrated network. Instead of inhibiting the realization of joint economies from efficient provision of multiple services on an integrated basis, the Commission should be looking to promote such efforts. Instead of adopting so-called "safeguards" that prevent effective resource sharing, the Commission should be looking to sweep away this kind of regulatory underbrush. "Safeguards" that "protect" consumers from reaping benefits from efficient utilization of an integrated network are an Orwellian misnomer. If the Commission is really serious about affording Information Age technical capabilities on a universal basis, it should be seeking ways to enable carriers to achieve whatever economies they can and move down their cost curves so that prices can be reduced to affordable levels for as many consumers as possible.

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[16] *See*, FCC, *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, September 28, 1994.

CERTIFICATE OF SERVICE

I hereby certify that I have this 30th day of June, 1995 served all parties to this action with a copy of the foregoing **COMMENTS** by placing a true and correct copy of the same in the United States Mail, postage prepaid, addressed to the party listed below.

Gwendolyn M. Burleson

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